VZCZCXRO2763
PP RUEHDBU
DE RUEHKV #0620/01 0981849
ZNY CCCCC ZZH
P 081849Z APR 09
FM AMEMBASSY KYIV
TO RUEHC/SECSTATE WASHDC PRIORITY 7591
INFO RUCNCIS/CIS COLLECTIVE PRIORITY
RUEHZG/NATO EU COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC PRIORITY

C O N F I D E N T I A L SECTION 01 OF 03 KYIV 000620

SIPDIS

DEPT FOR EUR, EUR/UMB, EEB/OMA

E.O. 12958: DECL: 04/07/2019
TAGS: EFIN EREL ETRD PGOV PREL XH UP
SUBJECT: ABSENT BILATERAL FINANCING, UKRAINE NEEDS BROADER
IFI SUPPORT

REF: A. KYIV 591
¶B. KYIV 576
¶C. KYIV 497
¶D. KYIV 360

Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4 (B) AND (D)

¶1. (C) Summary. As the IMF mission team looks set to return to Kyiv on April 9, President Yushchenko and Prime Minister Tymoshenko have assured the IMF of their intention to see through more budget cutbacks when the Rada votes on key laws on April 14. Nonetheless, it appears that Ukraine's ensuing projected budget deficit will remain far too large to refinance on either the country's miniscule domestic capital market or through foreign borrowing, where an appetite for Ukraine's risks remains nonexistent. Despite the GOU's efforts to secure large-scale bilateral budget support -- including a request to the United States from Yushchenko for a "symbolic" political pledge of direct aid -- local representatives of G-7 countries tell us their home offices are not prepared to extend loans to Ukraine. Russia, too, has put discussions over a loan package on hold. If Ukraine is to avoid monetizing the deficit through central bank borrowing, its only sources of additional budget support will likely come from the IMF and the World Bank. End summary.

Fiscal and Macroeconomic Worsening

¶2. (C) The IMF has told us that its Ukraine mission team, led by Ceyla Pazarbasioglu, will return to Kyiv on April 9. In an effort to get its program back on track, the IMF will focus on legislation that would reduce Ukraine's expected budget deficit to manageable levels. Both Yushchenko and Tymoshenko have publicly declared their intention to pass remaining anti-crisis bills on April 14. By virtue of BYuT's performance on March 31, Tymoshenko has proven she can back assurances with votes (Ref B). The President's powers of persuasion appear more limited, or else he may not be putting these powers to the test. Yushchenko notably did not respond when the Ambassador asked him on April 8 to push for votes in the Rada.

¶3. (C) Many Kyiv-based analysts now forecast that Ukraine's 2009 budget deficit could be close to 10 percent of GDP (at about $13 billion, nearly double initial IMF estimates). The budget deficit figure could bloom to 14 percent if bank recapitalization costs amount to $7 billion, as is now projected by some analysts. Financing needs for bank recapitalization will be met by a combination of capital increases by shareholders, EBRD/WB/IMF loans, and bank consolidations. But even if the GOU enacts legislation to cut pension spending and restructure state energy company Naftohaz's budget outlays and debt payments, it would still

need anywhere between $2.6 and 10.4 billion, depending on domestic sources of financing. The IMF will address these more pessimistic estimates, likely through a revision of its budget deficit projections, after the mission team returns to Kyiv this week.

Bilaterals Balk at Direct Budget Support

¶4. (C) Kyiv-based reps of potential bilateral donors are balking at the idea of direct loans to Ukraine, due to their own fiscal problems, as well as the widely shared conviction that additional financing should flow through multilateral institutions and be anchored by existing conditionalities and monitoring practices. U.K ambassador Leigh Turner acknowledged at a roundtable with the IMF, World Bank, and other G7 ambassadors that London would not be in a position to offer direct support, a position confirmed on March 19 by the Foreign Office in a widely circulated letter by Tim Hitchens, Director for European Political Affairs. "It is a question of political reluctance at home, driven by our own fiscal crisis," British embassy political section chief Duncan Allan told us on March 25, "but London believes the IFIs can deliver without major domestic political ramifications."

¶5. (C) Similarly, the German, Italian, French, and Japanese ambassadors have stated their governments' unwillingness to heed Kyiv's call for bilateral aid. The Europeans, each in their own fashion, collectively and individually have said no. Nonetheless, long-time regional analyst Anders Aslund voiced a more optimistic prognosis on budget assistance,

telling the Ambassador on April 3 that Ukraine's best bet would be for IFI support, augmented by certain European bilaterals, such as Sweden, Finland, and Austria, since these countries have either sufficient funds and/or the most to lose from their banks' exposure to Ukraine. To our knowledge, however, none of these countries has expressed a willingness to lend directly to Ukraine. Aslund opined that the EU, with its balance of payments support funds, would also need to consider co-financing. "So far, the EU has stopped at its border, but 'friendly and financially interested' countries will be trying to give the idea much greater exposure."

¶6. (C) Separately, Japanese diplomat Megumi Osugi-Stepien told us that a spirited discussion over financial assistance had arisen during PM Tymoshenko's recent trip to Tokyo. The Japanese have reacted with particular vehemence to Ukraine's recent decision to raise tariffs on imported cars by 13 percent (Ref C), since roughly 80 percent of Japan's exports to Ukraine are automobile-related. The tariff issue had torpedoed any consideration of financial assistance, and it was unclear whether Japan would be open to a loan even in absence of the tariff hike. But Osugi-Stepien told us on April 7 that if the Japanese finance ministry were to consider additional money for Ukraine, it would deliver such assistance through an IFI vehicle. "The money would still be from us," she said, "but IMF or World Bank lending would allow us to have greater safeguards."

¶7. (C) Osugi-Stepien also told us that, according to minutes of Tymoshenko's meeting with Japanese PM Aso on March 25, Aso told Tymoshenko that the IMF's program to tackle the 1998 Asian financial crisis had imposed unrealistically difficult conditionalities on Asian countries, and that Ukraine now needed to use those lessons to find its "own way" to continue spending. Osugi-Stepien shared with us that the Japanese MFA's internal meeting transcript indicated Tymoshenko smiling at Aso's remark. Osugi-Stepien also said that Minister of Economy Danylyshyn's claims, made in Tokyo at the end of the visit, that Japan had agreed to a $5 billion loan package under more favorable terms than the IMF Stand-By Arrangement (SBA), resulted from either unprofessional

journalism or a deliberate misstatement by the Minister. The Japanese embassy felt compelled to declare publicly that the GOJ had been "surprised" to learn from Danylyshyn that it was considering budget assistance.

¶8. (SBU) Outstanding negotiations over a Russian $5 billion loan likewise have been derailed. Moscow "indefinitely postponed" bilateral economic talks between Prime Ministers Putin and Tymoshenko that had been scheduled for early April, due to the joint EU-Ukraine declaration on gas transit, issued on March 23 in Brussels. Russian President Medvedev explicitly linked the two issues in a statement on March 31, saying it would be difficult to grant financial credits to cover Ukraine's budget deficit until the two states resolved their gas dispute. He added, "Our Ukrainian colleagues have asked us to give money. How can we give money if we cannot agree on such a crucial issue?" According to reputable local media reports, the Russian embassy in Kyiv has indicated that preparations for the economic talks continue, though no date has yet been set by Putin and Tymoshenko. It is as yet unclear whether the agreement on gas transit cooperation, announced on April 8 in Moscow, will make Russia more willing to extend budget support to Ukraine.

¶9. (C) After a meeting with G-8 and neighboring country ambasssdors on April 8, Yushchenko pulled aside the Ambassador to request a "symbolic" pledge of support for Ukraine as a "political" gesture. He stated that Russian assistance would have "too much of a political component" on its own, but it could be balanced by a signal from the USG. Yushchenko pleaded for the United States not to leave Ukraine "one-on-one" with Russia. Even a "modest sum" would show that the United States was not indifferent. The President reasoned that a U.S. pledge would also afford Ukraine greater leverage in accepting Russian assistance.

A More Lenient, Generous IMF?

¶10. (C) Our Kyiv-based G-7 interlocutors began expressing their skepticism of bilateral budget support even before the G-20 announced a significant capital infusion for the IMF. The announcement prompted the local media to speculate whether the G-20 declaration could lead to a bolstered

package for Ukraine. Prior to the announcement, Kyiv-based IMF resident representative Max Alier had already implicitly acknowledged that the Fund was calculating how it might increase its program in target countries such as Ukraine. When asked by the Ambassador on March 24 whether the IMF would consider providing more monies for Ukraine's budget deficit, Alier said, "We are bureaucrats and we serve (our masters)." Despite the fact that the Fund does not typically lend to meet countries' fiscal needs, Alier has hinted that the IMF has discussed this for Ukraine, especially in light of the lack of forthcoming bilateral support (Ref A).

Enlarging the World Bank Envelope

¶11. (SBU) With a projected program of $1.25 billion for Ukraine in 2009, the World Bank has reached the upper limit of its annual "envelope," local World Bank representatives have told us. Provided that the IMF program is on track and that Ukraine undertakes six key structural measures, the World Bank would disburse a $500 million Development Policy Loan for 2009 budget support and up to $750 million in loans for bank recapitalization (Ref D). The World Bank's Kyiv-based Senior Economist Pablo Saavedra told us that existing policy criteria would normally preclude additional lending, even if World Bank shareholders were to increase the Bank's overall capital. According to formal World Bank rules governing its treasury and operations, there are limited avenues for using the Bank as an instrument by which to route country-targeted external financing, said Saavedra.

¶12. (C) Nonetheless, the World Bank can be used as a "platform" for additional external lending in two ways. One would be through a so-called "top off" program, which Saavedra said was a mechanism the Bank and other donors have used to co-finance budget support after the World Bank reached its annual lending limit. A "top-off" could provide an additional budget support mechanism for Ukraine, said Saavedra, if bilateral donors would choose to bundle their support with the World Bank's structural reforms and planned 2009 loan packages.

¶13. (C) Another way the World Bank could serve as a bridge between Ukraine's fiscal needs and potential donor assistance would be to convene a Consultative Group, in which case a needs assessment and donor pledges would be solicited. "There is no model for this; it would be done in an ad hoc fashion," said Saavedra. In his discussion with the Ambassador, Anders Aslund commented positively about a potential Consultative Group, which he said would convene major IFIs, as well as interested bilateral donors. Aslund also said that western donors should "multilaterize" the Russians, preempting the need for bilateral budget support.

Comment

¶14. (C) Our G-7 interlocutors mostly agree that Ukraine cannot fund its 2009 budget deficit without external financial assistance. IMF envoy Pazarbasioglu will likely broach this subject during her trip to Kyiv, asking G-7 ambassadors again for bilateral budget support. We would support consideration of a symbolic pledge of USG direct budget assistance for political reasons. Yet, we expect that the G-20's multi-billion dollar capital infusion for the IMF will only strengthen the already prevalent view among our interlocutors that IFIs should be the international community's optimal vehicle for financing Ukraine's fiscal deficit.
TAYLOR